

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION INTO THE)	
FINANCIAL CONDITIONS OF)	ADMINISTRATIVE
SEVERAL WATER UTILITIES)	CASE NO. 366

O R D E R

On September 23, 1997, the Commission established this proceeding to gather information on the financial conditions of 27 water utilities. On March 27, 1998, the Commission requested additional information from 24 utilities and dismissed 3 utilities from this proceeding. After receiving and evaluating all responses, the Commission summarizes the results herein, discusses potential follow-up activities, and hereby terminates this proceeding.

SUMMARY

Several utilities have taken actions which appear to substantially address the Commission's concerns. For example, staff assistance to file rate increases has been requested by Monroe County Water District, Southern Mason Water District, Trimble County Water District No. 1, and Sandy Hook Water District. Hardeman Water District and Western Mason Water District have reported positive net incomes in 1997. David Water District transferred its assets to the City of Prestonsburg, and Dewitt Water District is still considering the possibility of merging with a neighboring utility. Caney Creek Water District has indicated its willingness to increase rates if necessary.

The remaining 17 utilities did not achieve positive net incomes in 1997, nor did they express specific intentions to file a comprehensive rate case. However, 10 of the 17 expressed an interest in meeting with Commission staff to discuss current rate-making procedures, and 3 suggested an interest in learning more about the implications of the Kentucky Supreme Court's 1986 Dewitt decision involving depreciation on contributed property. In addition, most of these utilities have recently filed, or intend to soon file, cases involving construction, financing, and rates pursuant to KRS 278.023.

The Commission will evaluate both the results of these KRS 278.023 cases and future annual reports of the above utilities to determine the need for additional review, such as staff field visits, and reserves the right to reopen this case if necessary.

The Commission is especially concerned that some utilities have not undergone comprehensive rate reviews in at least 15 years, while others have never had a comprehensive rate review based on historical test-period operations. The latter group includes Cawood Water District and Judy Water Association, whose initial and subsequent rates were established pursuant to KRS 278.023; it also includes Crittenden-Livingston Water District and Rattlesnake Ridge Water District, whose initial rates were based on projections and whose subsequent rates were established pursuant to KRS 278.023. The former group consists of Larue County Water District No. 1, Mud Creek Water District, Nicholas County Water District, and Western Fleming County Water District, none of which has had a full rate case review since at least 1981. We note that 6 of these 8 utilities are willing to meet with Commission staff to discuss PSC rate-making procedures.

REGIONAL APPROACHES TO WATER SERVICE

The Kentucky Long-Term Policy Research Center was created by the General Assembly in 1992 to identify and study issues of long-term significance to Kentucky. In carrying out its responsibilities, the Center has set forth 26 long-term goals designed to attain its vision of the future.¹ One of the goals is that "Kentucky will develop and enhance its physical infrastructure to support and sustain economic development and a high quality of life." According to the Center's 1998 report entitled "Visioning Kentucky's Future":

A modern and efficient physical infrastructure is the backbone of a state's economy. It is the support structure that sustains economic development, providing fundamental services without which businesses cannot function and citizens cannot prosper....

A sound physical infrastructure includes public access to safe drinking water, sewage and waste facilities, which are fundamental measures of public health, environmental protection, and quality of life. Significant improvements in these areas will be needed to advance development of the Commonwealth. In 1995, for example, small drinking water systems in the state accounted for 93 percent of violations cited by the Division of Water.²

Most of the utilities in this proceeding do not have a history of drinking water violations. However, the Commission is concerned that some of these utilities may lack a sufficient customer base necessary to affordably replace aging infrastructure, provide good customer service, and comply with the Safe Drinking Water Act ("SDWA") in the long-

¹ Visioning Kentucky's Future, Measures and Milestones 1998, The Kentucky Long-Term Policy Research Center, page v.

² Id., page 48.

term. According to a recent report from the National Research Council, without organizational changes, small water systems (defined as systems serving fewer than 500 people) will be unable to meet SDWA requirements over the long-term.³ Six of the utilities originally included in this proceeding serve less than 500 customers, although one has subsequently merged.

Utilities with financial or size constraints may also lack sufficient ability to successfully encourage economic development. Excess support infrastructure, including water and sewer facilities, is one of six factors that determine the locations for the greatest infusion of new and relocated corporate facilities, according to a national site selection expert.⁴ By virtue of economies of scale, larger utilities should be much better positioned than their smaller counterparts to affordably develop such plant capacity.

Smaller utilities may also be unable to afford adequate staff resources. The responses provided by utilities in this proceeding indicate that some are unable to fully comply with Commission regulations (e.g., meter testing). Some have not evaluated the potential effects upon their system of the 1996 amendments to the SDWA. As noted in audit reports, some smaller utilities' staffing levels are insufficient to adequately segregate financial responsibilities, as dictated by Generally Accepted Government Auditing Standards.

³ Journal of the American Water Works Association, January 1997, pages 58-60.

⁴ Dennis J. Donovan, Senior Managing Director of the Wadley-Donovan Group; Area Development Online <<http://www.area-development.com>>; 1996 Corporate Survey Analysis (December 1996.)

As we have previously noted, water districts and associations are generally doing a commendable job, under difficult circumstances, in expanding service to rural Kentucky.⁵ However, we strongly encourage water utility commissioners and local officials to consider regional approaches to provide better and more affordable water service.

It appears that some of the utilities in this proceeding could benefit from a regional approach because several lie in the same or adjacent counties; a few lie in close proximity to neighboring water utilities, and their potential for expansion appears limited. Absent revenue growth from new customers or increased rates, many will have to consider innovative ways to reduce costs in order to maintain financial viability. The solution for some could be mergers and/or greater consolidation of management services (such as billing, testing, and routine maintenance) with neighboring utilities. Mergers could also enhance an area's ability to fund water projects, as some federal funding mechanisms allocate scarce dollars by assigning additional points to merger projects.

In recent years, several Kentucky water utilities have merged with other utilities or transferred their assets to municipal utilities. In some cases, ratepayers of the merged utility have received rate reductions as a result; for others, the need for significant plant replacements appears to have been a primary motivation. A few noteworthy mergers in the past two years are the following:

⁵ Previous Order dated March 27, 1998, in this case, pages 1 and 2.

- The Commission approved the transfer of assets of the Stringtown Water District to the City of Lawrenceburg. Stringtown served 171 customers.⁶
- The Commission approved the transfer of assets of the Rochester Water District to the Butler County Water System.⁷ Approximately 69 percent of Rochester's 723 customers experienced a rate reduction, while 31 percent experienced a rate increase. The evidence indicated that the small rate increase to some customers was less than Rochester would need to operate separately and comply with Division of Water regulations.
- The Commission approved the transfer of assets of David Water District to the City of Prestonsburg.⁸ David served 120 customers and David's 1996 annual report suggests that it would have required a 60 percent rate increase to eliminate its 1996 operating loss had it remained a separate entity. In addition to not increasing, the rates of David's former customers will be reduced when defaulted debt is retired, according to the terms of the contract with Prestonsburg.
- The Commission approved the transfer of assets of the Prater Creek Water District to the City of Prestonsburg.⁹ Prater Creek served approximately 355 customers.

⁶ Case No. 97-523, The Application of Stringtown Water District, Anderson County, Kentucky, and The City of Lawrenceburg, Kentucky, For The Authorization of The Sale of All of Said District's Property, Assets, and Funds To the City of Lawrenceburg, Kentucky.

⁷ Case No. 97-008, The Joint Application of The Butler County Water System, Inc. and Rochester Water District For (A) Approval of A Joint Agreement To Merge Whereby Rochester Water District Would Be Merged Into Butler County Water System, Inc. Pursuant To The Provisions of KRS 278.020(4) and 807 KAR 5:001, et al.

⁸ Case No. 97-474, David Water District, Floyd County, Kentucky, For Authorization of Its Proposed Sale and Conveyance of All Its Water System Property, Assets, And Funds To The City of Prestonsburg, Kentucky.

⁹ Case No. 96-201, The Application of Prater Creek Water District, Floyd County, Kentucky, For Authorization of Its Proposed Sale and Conveyance of All Its Water System Property, Assets, and Funds To The City of Prestonsburg, Kentucky.

- The Commission approved the merger of Kenton County Water District and Campbell County Water District.¹⁰ The combined Northern Kentucky Water Service District is the largest water district in Kentucky, serving in excess of 55,000 customers.
- The Salt Lick Water Association transferred its assets to the City of Vanceburg.¹¹ Had it remained a separate entity, Salt Lick would have required a rate increase based upon its yearly operating deficits prior to the transfer.

In addition, the Commission has pending two formal cases to combine water utilities in Rockcastle and Logan counties.

Relative to consolidated management services, the geographic proximity of several utilities in this proceeding suggests that they might benefit from joint management and operational services. A particularly noteworthy example of such consolidation is in southern Kentucky where the Warren Rural Electric Cooperative Corporation provides services for more than 25,000 water customers of the Warren County Water and Sewer District, the Grayson County Water District, the Simpson County Water District, and the Butler County Water System. Recent PSC annual reports indicate that these districts' operation and maintenance expenses per customer tend to be lower than statewide averages. It is possible that this type of consolidation

¹⁰ Case No. 96-234, The Joint Application of Kenton County Water District No. 1 and Campbell County Kentucky Water District For Authority To Merge Into Northern Kentucky Water Service District, and For Authority For The Combined District To Operate.

¹¹ Case No. 96-436, The Application of Salt Lick Water Association, Inc., Lewis County, Kentucky, For Authorization of Its Proposed Sale and Conveyance of All of Its Water System Property, Assets and Funds To The City of Vanceburg, Kentucky.

could be successfully duplicated to benefit customers in other areas of Kentucky, and we urge local officials to aggressively explore that possibility.

We note that Dewitt Water District is still considering the possibility of merger with a neighboring utility. Dewitt should advise the Commission on the status of its merger efforts by the end of 1998.

PSC STAFF WATER TASK FORCE

Since the passage of the Safe Drinking Water Act Amendments of 1996, the PSC has created a staff Water Task Force ("Task Force") to consider long-term issues in the water industry and to develop a report. While the Task Force's deliberations have been separate from this proceeding, many of its issues are directly related. The Task Force's report will be available for review and comment when finished, and water utilities are invited to request a copy if they so desire.

BUSINESS PLANS

The responses filed in this proceeding suggest that many of the utilities may lack a formal, comprehensive, long-range planning process to address future system needs. In addition, some do not have a formal preventative maintenance program and others have not filed their meter testing reports or inspection programs with the Commission. We recognize that water utilities often lack the resources necessary to conduct business planning on a regular basis. However, we also believe that long-range planning is particularly important at this time in order to accomplish the goals of the SDWA, to replace aging infrastructure, to expand water service to all Kentuckians, and to maintain affordable rates, especially when those goals conflict due to limited financial resources.

Therefore, we suggest that water utilities consider developing comprehensive business plans to address long-term system needs. Such plans could include 1) a facilities plan listing in detail any improvements needed to the system, extensions of service to unserved areas, infrastructure repair and replacement and SDWA compliance costs; 2) a management plan which establishes responsibilities for the various operating functions; and 3) a financial plan which includes the amount and timing of capital investment required to implement the facilities plan, as well as the expected sources of financing including any potential rate increases. Such plans could address system needs for at least the next five years, timetables for completion of the necessary activities, and discussion of the potential for consolidation of services with neighboring utilities to reduce costs or provide improved service. We offer our staff's assistance should any water utility wish to develop such a plan.

The Commission would be particularly interested in reviewing any current or future long-range business plans developed by rapidly expanding water utilities. As shown in Attachment 1, this proceeding includes 8 of Kentucky's 20 fastest-growing water districts and associations for the period 1992 through 1996. These utilities face a significant long-term challenge in balancing rapid system expansion with the need to maintain affordable rates. We especially encourage those utilities to develop and disseminate their long-range business plans so that all interested parties, including the

Commission, local officials, present and future utility management, and the general public, have a greater understanding of how they intend to address this challenge.

SUMMARY

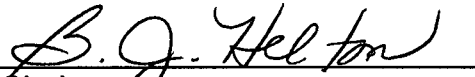
IT IS THEREFORE ORDERED that:


1. This proceeding is terminated and this case shall be removed from the Commission's docket.


2. Dewitt Water District shall file a status report on its merger efforts by no later than December 31, 1998.

Done at Frankfort, Kentucky, this 19th day of August, 1998.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director

Attachment 1

Kentucky's Fastest Growing Water Districts/Associations
(1992-1996)

	<u>Utility (County)</u>	<u>1992 Customers</u>	<u>1996 Customers</u>	<u>5-Year % Change</u>
1)	Caldwell (Caldwell)	99	350	253.54%
2)	Black Mountain (Harlan)	367	1,284	249.86%
3)	Corinth (Grant)	212	544	156.60%
4)	Dewitt (Knox)	189	477	152.38%
5)	Gallatin (Gallatin)	447	1,094	144.74%
6)	Cawood (Harlan)	294	621	111.22%
7)	Rattlesnake Ridge (Elliott)	1,031	1,997	93.70%
8)	East Clark (Clark)	804	1,550	92.79%
9)	Webster (Webster)	691	1,165	68.60%
10)	North Manchester WA (Clay)	836	1,382	65.31%
11)	North Mercer (Mercer)	1,800	2,913	61.83%
12)	Lyon (Lyon)	853	1,357	59.09%
13)	Sandy Hook (Elliott)	446	701	57.17%
14)	Allen (Allen)	1,634	2,567	57.10%
15)	North Hopkins (Hopkins)	674	1,036	53.17%
16)	Judy WA (Montgomery)	544	828	52.21%
17)	Harrison WA (Harrison)	2,449	3,706	51.33%
18)	Nicholas (Nicholas)	526	794	50.95%
19)	Adair (Adair)	2,250	3,353	49.02%
20)	South Anderson (Anderson)	925	1,375	48.65%

(Bold lettering indicates Administrative 366 utility)